

after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (a)(7) of this section is applicable to payments made after November 13, 1997.

[T.D. 7378, 40 FR 45429, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975, as amended by T.D. 8257, 54 FR 31819, Aug. 2, 1989; T.D. 8735, 62 FR 53500, Oct. 14, 1997]

§ 1.861-3 Dividends.

(a) *General*—(1) *Dividends included in gross income.* Gross income from sources within the United States includes a dividend described in subparagraph (2), (3), (4), or (5) of this paragraph. For purposes of subparagraphs (2), (3), and (4) of this paragraph, the term “dividend” shall have the same meaning as set forth in section 316 and the regulations thereunder. See subparagraph (5) of this paragraph for special rules with respect to certain dividends from a DISC or former DISC. See also paragraph (a)(6) of this section for special rules concerning substitute dividend payments received pursuant to a securities lending transaction.

(2) *Dividend from a domestic corporation.* A dividend described in this subparagraph is a dividend from a domestic corporation other than a domestic corporation entitled to the benefits of section 931, and other than a domestic corporation less than 20 percent of the gross income of which is shown to the satisfaction of the district director (or, if applicable, the Director of International Operations) to have been derived from sources within the United States, as determined under the provisions of sections 861 to 864, inclusive, and the regulations thereunder, for the 3-year period ending with the close of the taxable year of such corporation preceding the declaration of such dividend, or for such part of such period as the corporation has been in existence. See subparagraph (5) of this paragraph for the treatment of certain dividends from a DISC or former DISC.

(3) *Dividend from a foreign corporation*—(i) *In general.* (a) A dividend described in this subparagraph is a dividend from a foreign corporation (other than a dividend to which subparagraph (4) of this paragraph applies) unless

less than 50 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the taxable year in which occurs the declaration of such dividend (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct by such corporation of a trade or business in the United States, as determined under section 864(c) and § 1.864-3. Thus, no portion of a dividend from a foreign corporation shall be treated as income from sources within the United States under section 861(a)(2)(B) if less than 50 percent of the gross income of such foreign corporation from all sources for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States or if such foreign corporation had gross income for such 3-year period (or part thereof) but none was effectively connected with the conduct by such corporation of a trade or business in the United States.

(b) If 50 percent or more of the gross income from all sources of such foreign corporation for such 3-year period (or part thereof) was effectively connected with the conduct by such corporation of a trade or business in the United States, the amount of the dividend which is to be treated as income from sources within the United States under section 861(a)(2)(B) shall be the amount that bears the same ratio to such dividend as the gross income of such foreign corporation for such 3-year period (or part thereof) which was effectively connected with the conduct by such corporation of a trade or business in the United States bears to its gross income from all sources for such period.

(c) For purposes of this subdivision (i), the gross income which is effectively connected with the conduct of a trade or business in the United States includes the gross income which, pursuant to section 882 (d) or (e), is treated as income which is effectively connected with the conduct of a trade or business in the United States.

(ii) *Rule applicable in applying limitation on amount of foreign tax credit.* For purposes of determining under section 904 the limitation upon the amount of the foreign tax credit—

(a) So much of a dividend from a foreign corporation as exceeds (and only to the extent it so exceeds) the amount which is 100/85ths of the amount of the deduction allowable under section 245(a) in respect of such dividend, plus

(b) An amount which bears the same proportion to any section 78 dividend to which the dividend from the foreign corporation gives rise as the amount of the excess determined under (a) of this subdivision bears to the total amount of the dividend from the foreign corporation, shall, notwithstanding subdivision (i) of this subparagraph, be treated as income from sources without the United States. This subdivision applies to a dividend for which no dividends-received deduction is allowed under section 245 or for which the 85 percent dividends-received deduction is allowed under section 245(a) but does not apply to a dividend for which a deduction is allowable under section 245(b). All of a dividend for which the 100 percent dividends-received deduction is allowed under section 245(b) shall be treated as income from sources within the United States for purposes of determining under section 904 the limitation upon the amount of the foreign tax credit. If the amount of a distribution of property other than money (constituting a dividend under section 316) is determined by applying section 301(b)(1)(C), such amount must be used as the dividend for purposes of applying (a) of this subdivision even though the amount used for purposes of section 245(a) is determined by applying section 301(b)(1)(D). In making determinations under this subdivision, a dividend (other than a section 78 dividend referred to in (b) of this subdivision) shall be determined without regard to section 78.

(iii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples:

Example 1. D, a domestic corporation, owns 80 percent of the outstanding stock of M, a foreign manufacturing corporation. M, which makes its returns on the basis of the calendar year, has earnings and profits of \$200,000 for 1971 and 60 percent of its gross income for that year is effectively connected for 1971 with the conduct of a trade or business in the United States. For an uninterrupted period of 36 months ending on December 31, 1970, M has been engaged in trade or

business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 60 percent of its gross income from all sources for such period. The only distribution by M to D for 1971 is a cash dividend of \$100,000; of this amount, \$60,000 ($\$100,000 \times 60\%$) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and \$40,000 ($\$100,000 - \$60,000$) is treated under § 1.862-1(a)(2) as income from sources without the United States. Accordingly, under section 245(a), D is entitled to a dividends-received deduction of \$51,000 ($\$60,000 \times 85\%$), and under subdivision (ii) of this subparagraph \$40,000 ($\$100,000 - [\$51,000 \times 100/85]$) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 2. (a) The facts are the same as in example (1) except that the distribution for 1971 consists of property which has a fair market value of \$100,000 and an adjusted basis of \$30,000 in M's hands immediately before the distribution. The amount of the dividend under section 316 is \$58,000, determined by applying section 301(b)(1)(C) as follows:

Portion of adjusted basis of property attributable to gross income of M effectively connected for 1971 with conduct of trade or business in United States ($\$30,000 \times 60\%$)	\$18,000
Portion of fair market value of property attributable to gross income of M not effectively connected for 1971 with conduct of trade or business in United States ($\$100,000 \times 40\%$)	40,000
Total dividend	58,000

(b) Of the total dividend, \$34,800 ($\$58,000 \times 60\%$ (percentage applicable to 3-year period)) is treated under subdivision (i) of this subparagraph as income from sources within the United States, and \$23,200 ($\$58,000 \times 40\%$) is treated under § 1.862-1(a)(2) as income from sources without the United States. However, by reason of section 245(c) the adjusted basis of the property (\$30,000) is used under section 245(a) in determining the dividends-received deduction. Thus, under section 245(a), D is entitled to a dividends-received deduction of \$15,300 ($\$30,000 \times 60\% \times 85\%$).

(c) Under subdivision (ii) of this subparagraph, the amount of the dividend for purposes of applying (a) of that subdivision is the amount (\$58,000) determined by applying section 301(b)(1)(C) rather than the amount (\$30,000) determined by applying section 301(b)(1)(B). Accordingly, under subdivision (ii) of this subparagraph \$40,000 ($\$58,000 - [\$15,300 \times 100/85]$) is treated as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

Example 3. (a) D, a domestic corporation which makes its returns on the basis of the

§ 1.861-3

26 CFR Ch. I (4-1-01 Edition)

calendar year, owns 100 percent of the outstanding stock of N, a foreign corporation which is not a less developed country corporation under section 902(d). N, which makes its returns on the basis of the calendar year, has total gross income for 1971 of \$100,000, of which \$80,000 (including \$60,000 from sources within foreign country X) is effectively connected for that year with the conduct of a trade or business in the United States. For 1971 N is assumed to have paid \$27,000 of income taxes to country X and to have accumulated profits of \$81,000 for purposes of section 902(c)(1)(A). N's accumulated profits in excess of foreign income taxes amount to \$54,000. For 1971 D receives a cash dividend of \$42,000 from N, which is D's only income for that year.

(b) For 1971 D chooses the benefits of the foreign tax credit under section 901, and as a result is required under section 78 to include in gross income an amount equal to the foreign income taxes of \$21,000 ($\$27,000 \times \$42,000 / \$54,000$) it is deemed to have paid under section 902(a)(1). Thus, assuming no other deductions for the taxable year, D has gross income of \$63,000 ($\$42,000 + \$21,000$) for 1971 less a dividends-received deduction under section 245(a) of \$28,560 ($[\$42,000 \times \$80,000 / \$100,000] \times 85\%$), or taxable income for 1971 of \$34,440.

(c) Under subdivision (ii) of this subparagraph, for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit, \$12,600 is treated as income from sources without the United States, determined as follows:

Excess of dividend from N over amount which is 100/85ths of amount of sec. 245(a) deduction ($\$42,000 - [\$28,560 \times 100/85]$)	\$8,400
Proportionate part of sec. 78 dividend ($\$21,000 \times \$8,400 / \$42,000$)	4,200
Taxable income from sources without the United States	12,600

Example 4. A, an individual citizen of the United States who makes his return on the basis of the calendar year, receives in 1971 a cash dividend of \$10,000 from M, a foreign corporation, which makes its return on the basis of the calendar year. For the 3-year period ending with 1970 M has been engaged in trade or business in the United States and has received gross income effectively connected with the conduct of a trade or business in the United States amounting to 80 percent of its gross income from all sources for such period. Of the total dividend, \$8,000 ($\$10,000 \times 80\%$) is treated under subdivision (i) of this subparagraph as income from sources within the United States and \$2,000 ($\$10,000 - \$8,000$) is treated under § 1.862-1(a)(2) as income from sources without the United States. Since under section 245 no dividends received-deduction is allowable to an individual, A is entitled under subdivision (ii) of this subparagraph to treat the entire divi-

dend of \$10,000 ($\$10,000 - [\$0 \times 100/85]$) as income from sources without the United States for purposes of determining under section 904(a) (1) or (2) the limitation upon the amount of the foreign tax credit.

(4) *Dividend from a foreign corporation succeeding to earnings of a domestic corporation.* A dividend described in this subparagraph is a dividend from a foreign corporation, if such dividend is received by a corporation after December 31, 1959, but only to the extent that such dividend is treated by such recipient corporation under the provisions of § 1.243-3 as a dividend from a domestic corporation subject to taxation under chapter 1 of the Code. To the extent that this subparagraph applies to a dividend received from a foreign corporation, subparagraph (3) of this paragraph shall not apply to such dividend.

(5) *Certain dividends from a DISC or former DISC—(i) General rule.* A dividend described in this subparagraph is a dividend from a corporation that is a DISC or former DISC (as defined in section 992(a)) other than a dividend that—

(a) Is deemed paid by a DISC, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) to the extent provided in subdivision (iii) of this subparagraph or

(b) Reduces under § 1.996-3(b)(3) accumulated DISC income (as defined in subdivision (ii)(b) of this subparagraph) to the extent provided in subdivision (iv) of this subparagraph.

Thus, a dividend deemed paid under section 995(b)(1) (A), (B), or (C) (relating to certain deemed distributions in qualified years) will be treated in full as gross income from sources within the United States. To the extent that a dividend from a DISC or former DISC is paid out of other earnings and profits (as defined in § 1.996-3(d)), subparagraph (2) of this paragraph shall apply. To the extent that a dividend from a DISC or former DISC is paid out of previously taxed income (as defined in § 1.996-3(c)), see section 996(a)(3) (relating to the exclusion from gross income of amounts

distributed out of previously taxed income). In determining the source of income of certain dividends from a DISC or former DISC, the source of income from any transaction which gives rise to gross receipts (as defined in § 1.993-6), in the hands of the DISC or former DISC, is immaterial.

(ii) *Definitions.* For purposes of this subparagraph, the term—

(a) “Dividend from” means any amount actually distributed which is a dividend within the meaning of section 316 (including distributions to meet qualification requirements under section 992(c)) and any amount treated as a distribution taxable as a dividend pursuant to section 995(b) (relating to deemed distributions in qualified years or upon disqualification) or included in gross income as a dividend pursuant to section 995(c) (relating to gain on certain dispositions of stock in a DISC or former DISC), and

(b) “Accumulated DISC income” means the amount of accumulated DISC income as of the close of the taxable year immediately preceding the taxable year in which the dividend was made increased by the amount of DISC income for the taxable year in which the dividend was made (as determined under § 1.996-3(b)(2)).

(c) “Nonqualified export taxable income” means the taxable income of a DISC from any transaction which gives rise to gross receipts (as defined in § 1.993-6) which are not qualified export receipts (as defined in § 1.993-1) other than a transaction giving rise to gain described in section 995(b)(1) (B) or (C). For purposes of subdivisions (i)(b) and (iv) of this subparagraph, if by reason of section 995(c), gain is included in the shareholder’s gross income as a dividend, accumulated DISC income shall be treated as if it were reduced under § 1.996-3(b)(3).

(iii) *Determination of source of income for deemed distributions, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1)(D), (E), and (F).* (a) If for its taxable year a DISC does not have any nonqualified export taxable income, then for such year the entire amount treat-

ed, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend will be treated as gross income from sources without the United States.

(b) If for its taxable year a DISC has any nonqualified export taxable income, then for such year the portion of the amount treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as a deemed distribution taxable as a dividend that will be treated as income from sources within the United States shall be equal to the amount of such nonqualified export taxable income multiplied by the following fraction. The numerator of the fraction is the sum of the amounts treated, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1) (D), (E), and (F) as deemed distributions taxable as dividends. The denominator of the fraction is the taxable income of the DISC for the taxable year, reduced by the amounts treated under section 995(b)(1) (A), (B), and (C) as deemed distributions taxable as dividends. However, in no event shall the numerator exceed the denominator. The remainder of such dividend will be treated as gross income from sources without the United States.

(iv) *Determination of source of income for dividends that reduce accumulated DISC income.* (a) If no portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the entire amount of any dividend that reduces under § 1.996-3(b)(3) accumulated DISC income will be treated as income from sources without the United States.

(b) If any portion of the accumulated DISC income of a DISC or former DISC is attributable to nonqualified export taxable income from any transaction during a year for which it is (or is treated as) a DISC, then the portion of any dividend during its taxable year that reduces under § 1.996-3(b)(3) accumulated DISC income that will be treated as income from sources within the United States shall be equal to the amount of such dividend multiplied by a fraction (determined as of the close of such year) the numerator of which is the amount of accumulated DISC income attributable to nonqualified export taxable income, and the denominator of which is the total amount of accumulated DISC income. The remainder of such dividend will be treated as gross income from sources without the United States.

(v) *Special rules.* For purposes of subdivisions (iii) and (iv) of this subparagraph—

(a) Taxable income shall be determined under § 1.992-3(b)(2)(i) (relating to the computation of deficiency distribution), and

(b) The portion of any deemed distribution taxable as a dividend, for taxable years beginning before January 1, 1976, under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, and for taxable years beginning after December 31, 1975, under section 995(b)(1)(D), (E), and (F) or amount under § 1.996-3(b)(3) (i) through (iv) that is treated as gross income from sources within the United States during the taxable year shall be considered to reduce the amount of nonqualified export taxable income as of the close of such year.

(vi) *Illustrations.* This subparagraph may be illustrated by the following examples:

Example 1. (a) Y is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. X is its sole shareholder. In 1973, Y has \$18,000 of taxable income from qualified export receipts (none of which are interest and gains described in section 995(b)(1)(A), (B), and (C)) and \$1,000 of nonqualified export taxable income. Under these facts, X is deemed to have received a distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of \$9,500, i.e., \$19,000 X $\frac{1}{2}$. X is

treated under subdivision (iii)(b) of this subparagraph as having \$500, i.e., \$1,000 X \$9,500/\$19,000, from sources within the United States and \$9,000 from sources without the United States.

(b) For 1972, assume that Y did not have any nonqualified export taxable income. Pursuant to subdivision (v)(b) of this subparagraph, at the beginning of 1974, \$500 of Y's accumulated DISC income is attributable to nonqualified export taxable income (iii)(a) of this subparagraph), i.e., \$1,000—\$500.

Example 2. The facts are the same as in example (1) except that in 1973, in addition to the taxable income described in such example, Y has \$450 of taxable income from gross interest from producer's loans described in section 995(b)(1)(A). Under these facts, the deemed distribution of \$450 under section 995(b)(1)(A) is treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States. The deemed distribution under section 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976, of \$9,500 will be treated in the same manner as in example (1), i.e., \$1,000 X \$9,500/(\$19,450 - \$450).

Example 3. (a) The facts are the same as in example (1) except that in 1973, in addition to the distribution described in such example, Y makes a deemed distribution taxable as a dividend of \$100 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of all of its previously taxed income and of \$2,000 taxable as a dividend which reduces accumulated DISC income (as defined in subdivision (ii)(b) of this subparagraph). Under § 1.996-3(b)(3), accumulated DISC income is first reduced by the deemed distribution of \$100 and then by the actual distribution taxable as a dividend of \$2,000. As indicated in example (1), for 1972 Y did not have any nonqualified export taxable income. Assume that Y had accumulated DISC income of \$12,000 at the end of 1973, \$500 of which under example (1) is attributable to nonqualified export taxable income.

(b) The distribution from previously taxed income is excluded from gross income pursuant to section 996(a)(3).

(c) Of the deemed distribution of \$100, X is treated under subdivision (iv)(b) as having \$4.17, i.e., \$100×500/12,000, from sources within the United States and \$95.83, i.e., \$100—\$4.17, from sources without the United States.

(d) Of the actual distribution taxable as a dividend of \$2,000, X is treated under subdivision (iv)(b) as having \$83.33, i.e., \$2,000×500/12,000, from sources within the United States and \$1,916.67, i.e., \$2,000—\$83.33, from sources without the United States.

(e) The sum of the amounts deemed and actually distributed as dividends for 1973 that are treated as gross income from sources within the United States is as follows:

	Total dividend	Amount of dividend from sources within the United States
Deemed distribution under sec. 995(b)(1)(D) as in effect for taxable years beginning before January 1, 1976	\$9,500	\$500.00
Deemed distribution under section 995(b)(1)(G)	100	4.17
Actual distribution that reduces accumulated DISC income	2,000	83.33
Totals	\$11,600	\$587.50

Thus, pursuant to subdivision (v)(b) of this subparagraph, at the beginning of 1974 Y has \$412.50, *i.e.*, \$1,000—\$587.50, of nonqualified export taxable income.

(f) The result would be the same if Y made an actual distribution taxable as a dividend of \$1,500 on March 30, 1973, and another distribution of \$500 on December 31, 1973.

Example 4. (a) Z is a corporation which uses the calendar year as its taxable year and which elects to be treated as a DISC beginning with 1972. W is its sole shareholder. At the end of the 1976 Z has previously taxed income of \$12,000 and accumulated DISC income of \$4,000, \$900 of which is attributable to nonqualified export taxable income. In 1977, Z has \$20,050 of taxable income from qualified export receipts, of which \$550 is from gross income from producer's loans described in section 995(b)(1)(A); Z has \$950 of taxable income giving rise to gross receipts which are not qualified export receipts, of which \$450 is gain described in section 995(b)(1)(B). Of its total taxable income of \$21,000 (which is equal to its earnings and profits for 1977), \$1,000 is attributable to sales of military property. Z has an international boycott factor (determined under section 999)

of .10, and made an illegal bribe (within the meaning of section 162(c)) of \$1,265. The proportion which the amount of Z's adjusted base period export receipts bears to Z's export gross receipts for 1977 is .40 (see section 995(e)(1)). Z makes a deemed distribution taxable as a dividend of \$1,000 under section 995(b)(1)(G) (relating to foreign investment attributable to producer's loans) and actual distributions of \$32,000.

(b) The deemed distributions of \$550 under section 995(b)(1)(A) and \$450 under section 995(b)(1)(B) are treated in full under subdivision (i) of this subparagraph as gross income from sources within the United States.

(c) Under these facts, Z has also made the following deemed distributions taxable as dividends to W under the following subdivisions of section 995(b)(1):

(D)	\$500, <i>i.e.</i> , $\frac{1}{2} \times \$1,000$.
(E)	7,800, <i>i.e.</i> , $.40 \times [\$21,000 - (\$550 + \$450 + \$500)]$.
(F)(i)	5,850, <i>i.e.</i> , $\frac{1}{2} \times [\$21,000 - \$550 + \$450 + \$500 + 7,800]$.
(ii)	585, <i>i.e.</i> , $\$5,850 \times .10$
(iii)	1,265

Total .. 16,000

(d) The portion of the total amount of these deemed distributions (\$16,000 that is treated under the subdivision (iii)(b) as gross income from sources within the United States is computed as follows:

(1) The amount of nonqualified export taxable income is \$500, *i.e.*, taxable income giving rise to gross receipts which are not qualified export receipts (\$950) minus gain described in section 995(b)(1)(B) or (C) (\$450).

(2) $\$500 \times (\$16,000 / [\$21,000 - (\$550 + \$450)]) = \400 .

The remainder of these distributions, \$15,600 (\$16,000 minus \$400), is treated under subdivision (iii)(b) of this subparagraph as gross income from sources without the United States.

(e) The earnings and profits accounts of Z at the end of 1977 are computed as follows:

	Total earnings and profits	Previously taxed income	Accumulated DISC income attributable to taxable income from transactions which give rise to gross receipts which—	
			Are qualified export receipts	Are not qualified export receipts
(1) Balance: January 1, 1977	\$16,000	\$12,000	\$3,100	\$900
(2) Earnings and profits for 1977, before actual and section 995(b)(1)(G) distributions	21,000	17,000	3,900	¹ 100
(3) Balance: December 31, 1977	37,000	29,000	7,000	1,000
(4) Distribution under section 995(b)(1)(G)	1,000	(875)	² (125)
(5) Balance	37,000	30,000	6,125	875
(6) Actual distribution	(32,000)	(30,000)	(1,750)	³ (250)
(7) Balance: January 1, 1978	5,000	4,375	625

¹ The total of nonqualified export taxable income (\$500) minus the portion of such income, under subdivision (iii)(b) of this subparagraph, deemed distributed pursuant to section 995(b)(1)(D), (E), and (F) (\$400), as computed under (d)(2) of this example.

² Under subdivision (iv)(b) of this subparagraph, $\$1,000 / \$8,000 \times \$1,000$.

³ Under subdivision (iv)(b) of this subparagraph, $\$1,000 / \$8,000 \times \$2,000$ (amount of actual distribution that reduces accumulated DISC income).

(6) *Substitute dividend payments.* A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute dividend payment shall be sourced in the same manner as the distributions with respect to the transferred security for purposes of this section and § 1.862-1. See also §§ 1.864-5(b)(2)(iii), 1.871-7(b)(2) and 1.881-2(b)(2) for the character of such payments and § 1.894-1(c) for the application of tax treaties to these transactions.

(b) *Special rules—(1) Foreign corporation having no gross income for period preceding declaration of dividend.* If the foreign corporation has no gross income from any source for the 3-year period (or part thereof) specified in paragraph (a)(3)(i) of this section, the 50-percent test, or the apportionment formula, as the case may be, described in such paragraph shall be applied solely with respect to the taxable year of such corporation in which the declaration of the dividend occurs. This subparagraph applies whether the lack of gross income for the 3-year period (or part thereof) stems from the business inactivity of the foreign corporation, from the fact that such corporation is newly created or organized, or from any other cause.

(2) *Transitional rule.* For purposes of applying paragraph (a)(3)(i) of this section, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is from sources within the United States (determined as provided by sections 861 through 863, and the regulations thereunder, as in effect immediately before amendment

by section 102 of the Foreign Investors Tax Act of 1966 (Pub. L. 89-809, 80 Stat. 1541)) shall be treated as gross income for such period which is effectively connected with the conduct of a trade or business within the United States by such foreign corporation.

(3) *Gross income determinations.* In making determinations under subparagraph (2) or (3) of paragraph (a) of this section, or subparagraph (2) of this paragraph—

(i) The gross income of a domestic corporation is to be determined by excluding any items specifically excluded from gross income under chapter 1 of the Code.

(ii) The gross income of a foreign corporation which is effectively connected with the conduct of a trade or business in the United States is to be determined under section 882(b)(2) and by excluding any items specifically excluded from gross income under chapter 1 of the Code, and

(iii) The gross income from all sources of a foreign corporation is to be determined without regard to section 882(b) and without excluding any items otherwise specifically excluded from gross income under chapter 1 of the Code.

(c) *Statement with return.* Any taxpayer who is required to file a return and applies any provision of this section to exclude any dividend from his gross income must file with his return a statement setting forth the amount so excluded, the date of its receipt, the name and address of the corporation paying the dividend, and, if known, the location of the records which substantiate the amount of the exclusion. A statement from the paying corporation setting forth such information and indicating the amount of the dividend to be treated as income from sources within the United States may be used for this purpose. See §§ 1.6012-1(b)(1)(i) and 1.6012-2 (g)(1)(i).

(d) *Effective date.* Except as otherwise provided in this paragraph this section applies with respect to dividends received or accrued after December 31, 1966. Paragraph (a)(5) of this section applies to certain dividends from a DISC or former DISC in taxable years

ending after December 31, 1971. Paragraph (a)(6) of this section is applicable to payments made after November 13, 1997. For purposes of paragraph (a)(5) of this section, any reference to a distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after December 31, 1975, shall also constitute a reference to any distribution taxable as a dividend under section 995(b)(1)(F) (ii) and (iii) for taxable years beginning after November 30, 1975, but before January 1, 1976. For corresponding rules applicable with respect to dividends received or accrued before January 1, 1967, see 26 CFR 1.861-3 (Revised as of January 1, 1972).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6830, 30 FR 8046, June 23, 1965; T.D. 7378, 40 FR 45432, Oct. 2, 1975; 40 FR 48508, Oct. 16, 1975; T.D. 7472, 42 FR 12179, Mar. 3, 1977; T.D. 7591, 44 FR 5116, Jan. 25, 1979; T.D. 7854, 47 FR 51738, Nov. 17, 1982; T.D. 8735, 62 FR 53501, Oct. 14, 1997]

§ 1.861-4 Compensation for labor or personal services.

(a) *In general.* (1) Gross income from sources within the United States includes compensation for labor or personal services performed in the United States irrespective of the residence of the payer, the place in which the contract for service was made, or the place or time of payment; except that such compensation shall be deemed not to be income from sources within the United States, if—

(i) The labor or services are performed by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during his taxable year,

(ii) The compensation for such labor or services does not exceed in the aggregate a gross amount of \$3,000, and

(iii) The compensation is for labor or services performed as an employee of, or under any form of contract with—

(a) A nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

(b) An individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are per-

formed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation.

(2) As a general rule, the term “day”, as used in subparagraph (1)(i) of this paragraph, means a calendar day during any portion of which the nonresident alien individual is physically present in the United States.

(3) Solely for purposes of applying this paragraph, the nonresident alien individual, foreign partnership, or foreign corporation for which the nonresident alien individual is performing personal services in the United States shall not be considered to be engaged in trade or business in the United States by reason of the performance of such services by such individual.

(4) In determining for purposes of subparagraph (1)(ii) of this paragraph whether compensation received by the nonresident alien individual exceeds in the aggregate a gross amount of \$3,000, any amounts received by the individual from an employer as advances or reimbursements for travel expenses incurred on behalf of the employer shall be omitted from the compensation received by the individual, to the extent of expenses incurred, where he was required to account and did account to his employer for such expenses and has met the tests for such accounting provided in § 1.162-17 and paragraph (e)(4) of § 1.274-5. If advances or reimbursements exceed such expenses, the amount of the excess shall be included as compensation for personal services for purposes of such subparagraph. Pensions and retirement pay attributable to labor or personal services performed in the United States are not to be taken into account for purposes of subparagraph (1)(ii) of this paragraph. (5) For definition of the term “United States”, when used in a geographical sense, see sections 638 and 7701(a)(9).

(b) *Amount includible in gross income—*
(1) *Taxable years beginning after December 31, 1975.* (i) If a specific amount is paid for labor or personal services performed in the United States, that amount (if income from sources within the United States) shall be included in